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No. 347

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, A. D. 1950.

UNITED STATES OF AMERICA,

Petitioner,

vs.

E[redacted]R. LEWI[redacted]

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR RESPONDENT.

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Of Counsel.

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IN THE

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OCTOBER TERM, A. D. 1950.

UNITED STATES OF AMERICA,

Petitioner,

VS.

ELLIS R. LEWIS,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR RESPONDENT.

QUESTION PRESENTED.

The question presented is not adequately or properly stated by petitioner.

The question presented is: Where, as the result of a mistake, the respondent, who was in complete charge of the operations of his corporation-employer, directed the payment to himself and received, as part of his compensation for 1944, a bonus in excess of that to which he was entitled, and the excess bonus mistakenly paid was repaid

by the respondent to his employer in 1946, pursuant to a court decree which found that the excess bonus had been paid by mistake and ordered its repayment, and the employer in 1945 filed an amended income tax return for 1944, in which it deducted only the amount of bonus to which respondent was entitled, and paid the additional 1944 tax, plus interest, due by reason of not deducting in the amended return the excess bonus, is the excess bonus mistakenly paid to the respondent excludable from his income for 1944, and should the tax paid by the respondent on account of said excess bonus be refunded to him?

STATUTES INVOLVED.

It is respondent's position that Section 22 (a) of the Internal Revenue Code is the only section relevant to the issue in this case, and that Sections 41 and 42 are not relevant.

STATEMENT.

The statement made by petitioner is correct. For convenience, hereinafter the respondent will be called the "taxpayer" and his employer the "Company."

SUMMARY OF ARGUMENT.

I.

Petitioner Has Misconceived The Issue In This Case. Consequently, Most Of Its Argument And The Authorities Cited In Support Thereof Are Not Germane To The Issue.

Petitioner's argument is a treatise on the rules of accounting applicable to income taxes, plus an indulgence in speculation concerning feared and highly theoretical dire results of an affirmance of the judgment entered by the Court of Claims. Petitioner argues as if the issue presented in this case was a problem in accounting. Consequently, and perhaps intentionally, the argument adroitly and sedulously avoids and circumvents the actual issue in this case. Petitioner says (Petitioner's Brief, p. 12): "The issue here is, essentially, in which year should the balancing deduction be taken—the year of receipt or the year of refund?" Petitioner has misconceived the issue. The issue is: "Was the excess bonus paid to taxpayer in 1944 as a result of a mutual mistake of taxpayer and the Company and repaid by taxpayer to the Company in 1946, taxable income of the taxpayer?"

Having misconceived the issue, petitioner has naturally argued around it and not on it, and it follows that most of its argument and the cases cited in support thereof are not germane to the issue. Consequently, a detailed reply to petitioner's argument or a discussion of the cases cited in support thereof will not serve either to clarify or to determine the issue.

Petitioner's speculation follows a wide trail—a trail that leads nowhere, so far as the determination of the issue here presented is concerned. Petitioner speculates that the affirmance of the decision of the Court of Claims may tend to foster delayed payments of income taxes by irresponsible and unscrupulous persons; that it may imperil eventual collection of income taxes from taxpayers because they may have the financial ability to pay taxes in one year and not in another; and that it may result in injustice because a taxpayer may not be able to obtain the refund to which he is entitled because of the running of the Statute of Limitations. None of these speculative possibilities help to determine the question whether the money received by the taxpayer in 1944, to which the taxpayer was not entitled and which he had a definite and unconditional obligation to return from the moment of its receipt, and which he did return, was taxable income.

II.

The Excess Bonus Received By Taxpayer In 1944 As The Result Of A Mistake Was Not Taxable Income Of The Taxpayer.

Both the Circuit Court of Cook County, Illinois, and the United States Court of Claims found that the excess bonus received by the taxpayer was paid to him and received by him as the result of a mistake (R. 7, 9). When taxpayer received the excess bonus he was not entitled to it; although he got physical possession of it in 1944, it never belonged to him, he did not have title to it, and from the moment that he received it he was under the definite, unconditional obligation to return it. One who receives money as the result of a mistake is subject to such obligation. All of the facts which fixed the rights and obliga-

tions of the taxpayer and the Company occurred in 1944. The direct and unconditional obligation of the taxpayer to return the excess bonus came into existence immediately from the moment the bonus was received. It did not come into existence in 1946, when the decree of the Circuit Court of Cook County, Illinois ordered the taxpayer to return the bonus. The decree of the Circuit Court did not create the obligation but was simply declaratory of it. Therefore, under the principles settled by this Court, the excess bonus was not taxable income to the taxpayer.

The essence of petitioner's argument is that whatever money is received by a taxpayer is taxable income. This is not what Section 22(a) of the Internal Revenue Code says. Taxable income must be gains or profits or income. The money paid to the taxpayer because of a mistake was actually neither gain nor profit nor income. This principle has been declared by this Court in *Freuler* v. *Helvering*, 291 U.S. 35. The fact that the question there arose under a different section of the Internal Revenue Code from the one here involved does not affect the principle declared.

III.

The So-called "Claim Of Right" Doctrine Is Not Applicable To The Facts In This Case.

Petitioner's main position is that the so-called "claim of right" doctrine governs this case, and that the Court of Claims erroneously failed to apply that doctrine. In order to arrive at this position petitioner has consistently attempted to gloss over, ignore and escape from the one vital fact in this case: namely, that the excess bonus was paid to and received by the taxpayer as the result of a

mistake. Where such is the case, the so-called "claim of right" doctrine does not apply, for two reasons: (1) As has been said by the Court of Claims, the "claim of right" is neutralized by the mistake, and (2) the so-called "claim of right" doctrine relied upon by petitioner and stated in *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, has been limited or more clearly defined by this Court in *Commissioner* v. *Wilcox*, 327 U.S. 404, decided many years after the *North American Oil* case. In the *Wilcox* case this Court carefully considered the "claim of right" doctrine and concluded that the correct rule was (p. 408): "that a taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain, and (2) the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute gain." The facts in the instant case meet neither of the tests laid down in the *Wilcox* decision. There was no presence of a claim of right to the excess bonus, and there was a definite, unconditional obligation on the part of the taxpayer to repay or return the excess bonus, which obligation arose at the moment he received the bonus. Therefore, the "claim of right" doctrine does not apply to the facts in this case.

Taxpayer is not arguing whether the "claim of right" doctrine is good or bad, or whether it should be changed or modified; his position simply is that said doctrine is not applicable. That was the decision of the Court of Claims. That has been its position in previous cases. The Court of Claims has not, as petitioner asserts, "deviated" from the "claim of right" rule. It has applied the rule when the rule was applicable; it has refused to apply it when the rule was inapplicable because the receipt of money was due to a mistake.

IV.

The Position Of The Government Is Unjust And Unfair To The Taxpayer.

The Circuit Court of Cook County, Illinois and the Court of Claims, found that the agreement between the taxpayer and the Company was that the taxpayer's bonus for 1944 was to be ten per cent of the net profits of the Company *after* taxes (R. 7, 9). Therefore, when the taxpayer was paid and received the excess bonus (the difference between ten per cent of the net profits of the Company before taxes and ten per cent of the net profits after taxes) only one of two possibilities existed: Either (1) the taxpayer embezzled the excess bonus because he caused the Company to pay it, and he received it, knowing that the agreement between him and the Company was that his bonus was to be computed after taxes; or (2) he caused the Company to pay it, and he received it, as the result of a mutual mistake by the Company and by him. Upon the authority of *Commissioner* v. *Wilcox*, 327 U.S. 404, if the taxpayer embezzled the excess bonus, he is entitled to a refund. It would indeed be an anomaly if the taxpayer were entitled to the refund claimed by him if he embezzled the excess bonus, but not entitled to it if he received it as the result of an honest mistake.

In 1944 the taxpayer received the excess bonus as the result of an honest mistake, and he paid income taxes upon it. The Company, in its 1944 return, deducted the excess bonus paid to the taxpayer as an expense of the business and paid income taxes accordingly (R. 6). In 1945 the Company filed an amended 1944 return in which it deducted, as bonus compensation to taxpayer, the sum of $11,067.94 instead of the $21,924.00 deducted in its original return, and paid the additional tax based on the recompu-

tation (R. 6). Therefore, the Government has received as income taxes for 1944, from the Company, its taxes based upon a deduction of the amount which was actually due to the taxpayer and which was $10,856.06 less than the amount that he was mistakenly paid in 1944, and, from the taxpayer, taxes based upon the amount mistakenly paid to him, and which was $10,856.06 in excess of the amount to which he was entitled. Thus, both the Company and the taxpayer paid income taxes for 1944 upon the excess bonus, which the taxpayer later refunded. Under no theory of consistency, fairness or justice can petitioner maintain the position that it is entitled to the additional income tax p... l by the Company for 1944, but that the taxpayer is not entitled to a refund of the additional income tax for 1944 paid by him. As has been said by the Court of Claims in this case and similar cases, the Government's retention of the tax in this case is essentially unjust, and there is nothing to be said for it morally.

ARGUMENT.

I.

Petitioner Has Misconceived The Issue In This Case. Consequently, Most Of Its Argument And The Authorities Cited in Support Thereof Are Not Germane To The Issue.

Petitioner's argument is a learned treatise on the rules of accounting applicable to income taxes, plus an indulgence in speculation concerning the feared and highly theoretical dire results of an affirmance of the judgment entered by the Court of Claims. Petitioner argues as if the issue presented in this case was a problem in accounting. Consequently, and perhaps intentionally, the argument adroitly and sedulously avoids and circumvents the actual issue in this case. That issue is simple: "Was the excess bonus paid to taxpayer in 1944 as a result of a mutual mistake of taxpayer and the Company, and repaid by taxpayer to the Company in 1946, taxable income of the taxpayer?"

That "points of time be fixed between which income is to be measured for tax purposes" and that "net income shall be computed upon the basis of taxpayer's annual accounting period" (Petitioner's Brief, pp. 9-10, 15-17), that the "claim of right" doctrine of *North American Oil Co.* v. *Burnet*, 286 U.S. 417, "follows as a necessary corollary" (Petitioner's Brief, pp. 10, 17-24), that "earnings or gain is taxable in the year of receipt even though the taxpayer's right to the money is subject to dispute or even though it is subject to an obligation to restore, which is admitted or uncontroverted, but at the same time, contingent or indefinite" (Petitioner's

Brief, pp. 11, 24-34), may be accounting or legal questions of importance in other matters or cases. But they are irrelevant in this case, and do not govern or even affect the determination of the issue here presented. Yet they constitute all the basic points of petitioner's argument.

Petitioner's propositions relating to annual accounting and the *North American Oil* case are applicable only when the receipt involved is actually taxable income. They do not determine what is or is not income, which is the issue in this case, nor have they any bearing upon that issue. Likewise, the law relating to the receipt of that which is concededly income, but subject to a contingent liability to restore, has no application. Obviously, the contingency may never occur and, therefore, the obligation to restore may never arise. Also, such obligation, if it ever arises, does not arise until the contingency occurs. In the instant case there was no contingency or indefiniteness involved. When money is received by a person because of a mistake, it does not belong to the recipient, and there exists, from the moment of its receipt, an unconditional and definite obligation upon him to return it.

Petitioner has tersely summarized its argument in its statement that "The issue here is, essentially, in what year shall the balancing deduction be taken—the year of receipt or the year of refund" (Petitioner's Brief, p. 12). That, as we have said, is not the issue here. It follows that, as petitioner has misconceived the issue, and consequently has argued around it, and not on it, most of its argument and the cases cited in support thereof are not germane and require no answer.

On pages 14-15 of its brief, petitioner recites what it claims "are the undisputed facts upon which it must be determined whether or not the bonus constituted in-

come to taxpayer in 1944." Petitioner's statement is not correct. Its recital of the facts omits the most salient fact,—that the taxpayer received the excess bonus because of and as a result of a mistake. This is the vital and basic factor which distinguishes this case from practically all of the income tax cases cited and relied upon by the petitioner.

Following a trail that leads nowhere, so far as the determination of the issue here is concerned, petitioner theorizes that the decision below tends to foster delayed payment and speculation on the part of the irresponsible and unscrupulous at the expense of the Government and the general body of law-abiding taxpayers. If some taxpayers are irresponsible and unscrupulous, that is too bad; they may pay no taxes at all. Their irresponsibility and unscrupulousness have as much bearing upon the issue here as the fact that some people live without benefit of clergy has upon the validity of a marriage. Actually, the person who receives income as the result of a mistake will always pay his income taxes promptly (if he is not irresponsible or unscrupulous) because he does not know until later that a mistake has been made.

Petitioner also speculates that, if the judgment below is affirmed, eventual collection of income taxes may be imperiled because some taxpayers may have the financial ability to pay their taxes in one year and may not have that ability in another year. We suggest that the question, whether the excess bonus the taxpayer received in 1944 was or was not taxable income, cannot be determined by speculating on the financial ability of other taxpayers to pay in one year and not in another year.

Petitioner also asks this Court to reverse the judgment below because of the Government's sympathy for a tax-

payer who may not be able to obtain a refund because he may not have repaid the money to which he was not entitled until after the Statute of Limitations has run upon his claim for refund. This possible situation may be a hardship in some case upon some taxpayer, but it has nothing to do with the issue here. There are many hardships in the Income Tax Law. For instance, a taxpayer, because of a mistake in computation, may pay income taxes which he does not owe, but if said taxpayer or the Government does not discover the mistake within the refund period, said taxpayer cannot obtain a refund and simply loses the amount of the tax which he did not owe and which he should not have paid.

One main contention of petitioner seems to be that, because tax accounting must be on an annual basis, if the judgment entered by the Court of Claims is affirmed, the entire revenue of the United States would have havoc wreaked upon it.

This contention, we suggest, is the product of a vivid imagination. Of course, the revenues of the United States must be determined on an annual basis, and that is exactly what the taxpayer is contending for, and nothing in the principles which sustain the judgment below contravenes this rule. That tax accounting of the United States must be on an annual basis means, in essence, no more than that a taxpayer's annual tax shall be based upon events which occur entirely within the tax year. That proposition is not violated by the decision below. All of the events which deprived the excess bonus received by the taxpayer of the character of taxable income occurred in 1944. The decision of the Circuit Court of Cook County, Illinois in 1946 merely recognized and confirmed what actually occurred in 1944. If the

fears of petitioner were well grounded, then the finances of the United States should have been thrown into chaos by the decision of this Court in *Freuler* v. *Helvering*, 291 U.S. 35.

In that case the beneficiaries of a trust had been paid the entire income of the trust in the taxable year. They paid income tax only on a part of the income received by them, excluding from their taxable income a certain amount which they had received because the trustee had not retained that amount for depreciation purposes. The Commissioner assessed a deficiency. Many years subsequent to the taxable year and to the actual distribution of the income, the state court having jurisdiction over the trust determined that the trustee should not have distributed the entire income but should have withheld and retained for remaindermen a certain amount for depreciation, and ordered the beneficiaries to repay the excess amounts to the trustee. The beneficiaries complied with this order; not by repaying the amounts, but by giving their non-interest bearing promissory notes to the presumptive remaindermen, payable at the time the remainders should vest in possession. This Court held that the beneficiaries were not taxable upon the amounts paid them in excess of what they should have been paid in the proper administration of the trust. The statement of the Court of Claims below concerning the *Freuler* case is a complete answer to petitioner's contention that, because Government tax accounting must be on an annual basis, an affirmance of the judgment below would wreak havoc upon the Government's finances. The Court of Claims said, concerning this Court's decision in the *Freuler* case:

> "The fact that the court so interpreted the statute as to make taxability depend upon the outcome of litigation as to whether the beneficiaries actually receiv-

> ing the income were legally entitled to keep it or not seems to us to discount very heavily the idea that the finances of the nation would be thrown into disorder if the Government were allowed to tax as income only that which is, in fact, income to the taxpayer, and not that which only seems to be income because he is mistaken as to his right to keep it." (R. 11).

Petitioner says,—what it considers to be a conclusive argument,—that: "The uniform result of the established system has been denial both to Government and to taxpayers of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment" (Petitioner's Brief, p. 14). Petitioner's statement is true if the money received by the taxpayer is "income"; the statement is not true if the money received by the taxpayer is not income. *Freuler* v. *Helvering*, 291 U.S. 35, so holds.

Furthermore, Congress has recognized that the finances of the Government will not, as feared by the petitioner, collapse if the doors are not firmly barred and sealed at the beginning and end of an annual period. Petitioner's brief itself cites various sections of the Internal Revenue Code which provide for adjustment of a prior year's taxes by reason of subsequent events. (Foot-note 7, Petitioner's Brief, p. 35).

The administration of the Internal Revenue Code is replete with instances which refute petitioner's argument. A few illustrations will suffice: In 1944, A receives money which he erroneously and mistakenly believes is income and reports it as such. In 1946, the Commissioner of Internal Revenue determines that the transaction was a gift and not income to A. Assuredly the Commissioner would not hesitate to refund the excess tax paid by A for 1944.

If A, in March, 1945, files his income tax return for 1944 and makes a clerical error in that return, or includes in his income for 1944 that which is not income, or excludes from his income for 1944 that which is income, it is his duty and it is the duty of the Commissioner of Internal Revenue to correct the mistake. The result is that A, when the mistake is discovered, pays an additional tax for 1944 or is refunded part of the tax he paid for 1944. He does not pay an additional tax or make a deduction from his income for the year in which the mistake is discovered.

The Company, in March, 1945, in its income tax return for 1944, took a deduction for the entire compensation, including the excess bonus paid to the taxpayer in 1944. When, later in 1945, the Company discovered the mistake it had made, it filed an amended 1944 return and paid an additional tax (R. 9). The taxpayer paid income tax on the entire compensation received by him in 1944, including the excess bonus for that year. Had the Company waited until the excess bonus had been repaid to it in December, 1946, and then had attempted to include the money repaid to it in its 1946 return, and at the same time to have stood by its original 1944 return, would the petitioner have approved? It certainly would not have.

As petitioner's propositions concerning the necessity of annual accounting are irrelevant to, and not helpful in determining, the issue in this case, there would be no purpose in discussing the cases cited and quoted from by petitioner in support of said propositions. The many other cases, cited and relied upon by petitioner in support of the "claim of right" theory, will be referred to under taxpayer's Points II and III.

II.

The Excess Bonus Received By Taxpayer In 1944, As The Result Of A Mistake, Was Not Taxable Income Of The Taxpayer.

The petitioner's claim is that the taxpayer received the excess bonus in 1944 under a claim of right; that, therefore, the so-called "claim of right" doctrine applies to this case and under it the taxpayer is not entitled to a refund of the income taxes he paid for 1944 on the excess bonus.

In asserting this position, petitioner ignores the fundamental fact that the taxpayer, when in 1944 he received the excess bonus, was not entitled to it and that he received it because of a mistake. Both the Circuit Court of Cook County, Illinois, and the United States Court of Claims so found (R, 7, 9) and that finding is not before this Court for review.[1] This fundamental fact makes the so-called "claim of right" doctrine inapplicable to this case and entitles the respondent to a refund of the income taxes paid by him on said excess bonus.

When the taxpayer received the excess bonus he was not entitled to it; although he got physical possession of it in 1944, it never belonged to him, he did not have title to it, and from the moment that he received it, he was under the definite, unconditional obligation to return it.

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[1]See Specification Of Errors To Be Urged (Petitioner's Brief, pp. 8-9). Petitioner indirectly attempts to contest this finding (Petitioner's Brief, p. 32), which petitioner has no right to do. Petitioner also says, p. 32, "Certainly, it is not pertinent to the present problem that in any litigation one party or the other, or both, may be said to have been mistaken on the facts or law." Not only is it pertinent, but it is the crux of this case.

It was, therefore, not a part of his 1944 taxable gross income within Sec. 22(a) of the Internal Revenue Code.

The law is that one who receives money under a mistake is subject to the definite, unconditional obligation to repay or return said money, and that said obligation arises at the moment that the money was received.

Leather Manufacturers' Bank v. *Merchants Bank*, 128 U. S. 26;

New York Life Insurance Company v. *State*, 192 Wis. 404;

Poindexter v. *The Equitable Life Assurance Society*, 127 W. Va. 671;

International Bank v. *Bartalott*, 11 Ill. App. 620;

Richardson v. *Bales*, 66 Ark. 452;

Sturgis v. *Preston*, 134 Mass. 372;

5 *Williston on Contracts* (Rev. Ed.) § 1574 and cases there cited;

American Law Institute, *Restatement of Law of Restitution*, §§ 18, 20.

In the *Leather Manufacturers' Bank* case, this Court held that, if a bank, upon which a check is drawn payable to a particular person or order, pays the amount of the check to one presenting it with a forged endorsement of the payee's name, both parties supposing the endorsement to be genuine, a right of action to recover back the money accrues at the date of the payment, and the statute of limitations begins to run from that date.

The *New York Life Insurance Co.* case presented a situation on this proposition practically identical with that in the instant case and the decision there unequivocally demonstrates that taxpayer's obligation to repay the excess

bonus arose at the time it was paid to him and not at the time of the decree of the Circuit Court of Cook County, Illinois. The New York Life Insurance Company was a New York corporation doing business in Wisconsin. The Wisconsin law in effect in 1917 and 1918 provided, in substance, that a foreign insurance company should pay the same license tax as a Wisconsin insurance company was required to pay to the domicillary state of the foreign corporation by the laws of such state. At that time the ruling of the New York State Tax Department was that the New York law required a Wisconsin corporation to pay a tax of 1% of its gross receipts without any deduction for refunded premiums. The New York Life Insurance Company paid its tax to Wisconsin on that basis. Thereafter it was held by a New York court that the ruling of the New York State Tax Department was erroneous and that a deduction should be allowed for refunded premiums. Plaintiff sued to recover the license taxes it had paid to Wisconsin in excess of what it should have paid, based upon the New York law, as the New York court had found it to be. Suit was begun more than six years after the payment of the Wisconsin tax had been made, but less than six years after the decision of the New York court. The defense of the six year Statute of Limitations was interposed. The Wisconsin Court held that the cause of action accrued and the Statute of Limitations began to run when the excess payment was made to the State of Wisconsin and not when the New York court decided what the law of New York was.

In the *Poindexter* case, excess premiums were paid to an insurance company as a result of the mutual mistake of the insured and the insurer. The court said (pp. 681-682):

> "The payment and receipt of these excess sums was a purely mutual mistake, raising no blame against either party. * * * The insured had the absolute right to recover these excess payments from the instant they were paid, and the insurer the duty, equally absolute, to repay them. This stood their rights immediately after the payments."

The factual situation in this case makes irrelevant almost all of the cases relied upon by the petitioner. Its first group of cases are those where, in the words of petitioner, "the earning or gain has been held taxable in the year of receipt, even though, * * * the taxpayer's right to the money is subject to dispute, and liability to restore its equivalent may be, or is being, asserted." (Petitioner's Brief, pp. 25-27). When the taxpayer was paid the excess bonus there was no dispute.[2] It was paid to him because the Company and the taxpayer mistakenly believed at that time that he was entitled to it. There could not have been a dispute because the fact that the money was paid by reason of a mistake negatives the possibility of a dispute.

The next group of cases relied upon by petitioner are those which have held the tax properly collected in the year of receipt "even though the income is subject to an obligation to restore, which is admitted or uncontroverted, but at the same time, contingent or indefinite." (Petitioner's Brief, pp. 27-29). Petitioner itself has characterized these cases as follows:

> "In each of these cases * * * there were present at the time of receipt a bona fide claim of right to the alleged gain, title to it and unrestricted freedom in disposition, and there was absent a definite, unqualified and unconditional obligation to repay or return its equivalent."

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[2] Petitioner concedes this. See Petitioner's Brief, p. 37.

Petitioner's characterization of these cases distinguishes them from the instant case. In this case, at the time of receipt, there was present, not absent, a definite, unqualified and unconditional obligation to repay or return the excess bonus.

In the instant case, the events which fixed the rights and obligations of the taxpayer and the Company occurred in 1944. The direct and unconditional obligation of the taxpayer came into existence immediately at the moment the excess bonus was received. It did not arise for the first time in 1946, when the Circuit Court of Cook County, Illinois ordered the taxpayer to return the excess bonus. The decree of the Circuit Court was simply declaratory of the direct, unconditional obligation which came into existence in 1944.

Analogous situations are innumerable. For instance, if a statute is declared unconstitutional and void by a court of last resort, there is no doubt that the statute was void from the date of its enactment. Likewise, there is no doubt that, if a contract is declared void because it is against public policy, it was void from its inception.

The case of *Freuler* v. *Helvering*, 291 U.S. 35, is also decisive of this principle that the decree of the Circuit Court of Cook County did not create the obligation of the taxpayer to return the money, but that the obligation came into existence in 1944, and the decree of the Circuit Court was merely declaratory of that obligation. The facts in the *Freuler* case have been previously stated (*supra*, p. 13). This Court there held that the income of the trust received by the beneficiaries was not taxable income, because the state court had held, years after said money was paid, that it was mistakenly paid to the beneficiaries and had ordered them to repay it, which

they had done. If the obligation to repay had not come into existence immediately upon the receipt of the money, this Court should have sustained the Commissioner's assessment on the money so received and allowed the beneficiaries a deduction in the year in which they repaid the money.

The essence of petitioner's argument is that whatever money is received by taxpayer is taxable income. This is not what Section 22(a) of the Internal Revenue Code says. Taxable income, under that section, must be gains or profits or income. The money paid to the taxpayer as the result of a mistake, and to which he was not entitled and which he was under obligation to return from the moment he received it, was neither gain nor profit nor income. The mere fact that it was received by him did not make it income. The principles governing this situation were clearly set forth by this Court in the *Freuler* case.

It was there held that, since it had been determined by the state court that certain income from a trust should never have been paid to the beneficiaries thereof, that they were not entitled thereto, and that they were obligated to repay the same, said income was not taxable income. This Court said (p. 42):

> "* * * The test of taxability to the beneficiary is not receipt of income, but the present right to receive it. Clearly an overpayment to a beneficiary by mistake of law or fact, would render him liable for the taxable year under consideration, not on the amount paid, but on that payable."

The dissent of Justices Cardozo, Brandeis and Stone in that case was not based on any dissent from the principle announced above, but on the position that the bene-

ficiaries had not in fact repaid to the trustee that part of the income to which the beneficiaries were not entitled. The principle determining the case and which is determinative of the instant case was approved in the dissenting opinion.

In the instant case, the taxpayer paid the tax on the excess bonus in 1945, when he paid his 1944 income tax, and in 1946 repaid in full to the Company the amount of the excess bonus.

Petitioner attempts to distinguish the *Freuler* case (Petitioner's Brief, pp. 23-24) on the ground that said case involved only the construction of Sec. 219(d) of the Revenue Act of 1921 and was merely an example of an express statutory exception to the general principle of annual accounting. The distinction made by petitioner is not valid. The exception made in Sec. 219(d) to the general principle of annual accounting was not involved in the *Freuler case*. Insofar as Sec. 219(d) taxed income "distributable", it referred to income which the beneficiary was entitled to receive, but had not actually received.[3]

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[3]The pertinent part of Sec. 219(d) provided:

"(d) * * * there shall be included in computing the net income of each beneficiary that part of the income of the estate or trust for its taxable year which, pursuant to the instrument or order governing the distribution, is distributable to such beneficiary, whether distributed or not * * *." (Emphasis supplied)

The Court below recognized the speciousness of petitioner's attempt to distinguish the Freuler case. In this connection it said:

"We recognize, of course, that the Freuler case involved a special section of the Revenue Act which had its own wording. The use in that section of the word 'distributable' would seem to be accounted for by the fact that Congress intended to tax to beneficiaries money which was in fact available or owing to them by their trustees, even before it had actually been paid over to them." (R. 10-11).

Section 219(d) made no special provision different from the general concept of income contained in Sec. 22(a) with reference to moneys actually received by the beneficiary. Consequently, the decision in the *Freuler* case did not turn upon any special statute, but turned upon the principle that money received as the result of a mistake of law or fact, and later returned, does not constitute income to the recipient.

The legal principle of the *Freuler* case, that money received by reason of a mistake and which is later repaid is not taxable income to the recipient, which is the principle that controls this case, was followed in

Saltonstall v. *Hassett, et al.* (U.S.D.C. Mass. 1940) 32 F. Supp. 583.

There the beneficiary of a trust sued for a refund of income taxes paid on money she received from the trustees, which the trustees and the beneficiary subsequently determined had been paid because of a mistake. In holding that the beneficiary was entitled to a refund, the Court said, in part, (p. 588):

> "Under the circumstances it is obvious that some of these amounts were paid to the plaintiff by mistake and she was burdened with the obligation of paying them back. * * * These payments * * * upon which the plaintiff paid tax, were not taxable income to the plaintiff, but should be taxed to the trustees. This is plainly so under the doctrine of *Freuler* v. *Helfering*, 291 U.S. 35, 42."

We submit that it is the law, and that this Court has so held, that money paid to a person which actually was not his and to which he was not entitled and which was paid to him because of a mistake of law or fact and which he later repaid, is not taxable income. The multitude of

cases cited by petitioner, with the possible exception of one or two, do not contravene that legal principle. Incidentally, a considerable number of cases cited by petitioner do not have even a remote bearing upon the issue in this case. We believe that an analysis of this Court's decisions in the three cases of *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, *Freuler* v. *Helvering*, 291 U.S. 35, and *Commissioner* v. *Wilcox*, 327 U.S. 404, will amply suffice to determine that taxpayer's position is correct and that the judgment of the Court of Claims should be affirmed. A goodly number of lower courts' decisions might be cited to sustain the legal principles advanced by taxpayer. The only weight that they would carry is due to the possible persuasiveness of their argument, and it is our thought that it is unnecessary to burden this Court by discussing them.

III.

The So-called "Claim Of Right" Doctrine Is Not Applicable To The Facts In This Case.

Except for its emphasis upon the rule of annual accounting, which we have already discussed, petitioner's sole claim is that the taxpayer received the excess bonus in 1944 under a claim of right; that, therefore, the so-called "claim of right" doctrine applies to this case and, consequently, the taxpayer is not entitled to a refund of the income taxes he paid for 1944 on the excess bonus.

In asserting this position petitioner glosses over the fundamental fact that the taxpayer, when in 1944 he received the excess bonus, was not entitled to it, that he received it because of a mistake, and that at the time he received it he was under the direct and unconditional obligation to return or repay it. This fundamental fact

makes the "claim of right" doctrine inapplicable to this case. We believe that this Court has already so held. Reason and every principle of equity support that conclusion.

It is true that, when the taxpayer received the excess bonus he believed that he was entitled to it. But the existence of that belief does not bring this case within the "claim of right" doctrine, although the petitioner apparently bases its case entirely upon the fact of said belief. The belief of the taxpayer was based upon a state of facts which did not exist. Had the taxpayer and the Company then been cognizant of the true facts, said taxpayer would not have been paid the excess bonus. The result of the then lack of knowledge of said taxpayer and the Company was a mistake and the belief of taxpayer that he was entitled to the excess bonus was based upon the same non-existent facts which resulted in the mistake. Such a belief does not constitute a "claim of right". The mistake neutralizes the "claim of right". This principle has been clearly stated by the Court of Claims in

Greenwald v. *United States*, 57 F. Supp. 569, and
Gargaro v. *United States*, 73 F. Supp. 973.

In the *Greenwald* case the Court said (p. 572):

> "This doctrine [the 'claim of right' doctrine] has been applied in many cases. The plaintiff urges that it is not applicable here, because his receipt of the bonuses was due to a mistake of fact. * * * We agree with the plaintiff. * * *

(p. 573):

> "We conclude, therefore, that the 'claim of right' doctrine does not apply to the plaintiff's situation. He overpaid his taxes because of a mistake of fact."

In the *Gargaro* case the Court said (p. 975):

> "Plaintiff's claim of right in this case, as in the *Greenwald* case, *supra*, was neutralized by the fact that he was ignorant of the relevant facts."

Petitioner contends that this Court's ruling in *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, announcing the "claim of right" doctrine, is controlling here and that it is a corollary of the principle of annual accounting, so voluminously discussed by petitioner. If it be conceded that the rule announced in the *North American Oil* case is a corollary of the annual accounting principle, then that points up the fact that the "claim of right" doctrine of the *North American Oil* case does not control this case, but on the contrary has no application thereto. For, as we have shown, the annual accounting principle does not determine what is or is not taxable income.

In that case the United States had brought suit before 1916 in the U. S. District Court to oust the taxpayer from possession of oil land. The Court appointed a receiver in 1916 to operate the property and hold the profits. In 1917 the Court entered its final decree dismissing the suit and the receiver thereupon paid to the taxpayer the 1916 profits on the property in his hands. The United States appealed the decree; in 1920 the Circuit Court of Appeals confirmed; and in 1922 the Supreme Court dismissed the Government's further appeal. In 1918 said taxpayer had included the 1916 profits on the property, paid to the taxpayer by the receiver in 1917, in an amended return for 1916. The Commissioner of Internal Revenue contended that said profits were taxable income for 1917, when they were paid to the taxpayer by the receiver. The taxpayer contended that

they were either 1916 income or income for 1922, when the taxpayer's right to the profits was finally confirmed. The sole question before this Court was, in what year the profits should have been reported and taxed as income. This Court held that the profits were income in 1917, the year they were actually received by the taxpayer.

There was no issue as to whether the profits were taxable income; the Court said (p. 422): "It is conceded that the net profits earned by the property during the receivership constituted income."

In attempting to distinguish the case of *Freuler* v. *Helvering*, 291 U.S. 35, which we have previously discussed, petitioner says (Petitioner's Brief, p. 23) that the *Freuler* case did not have any bearing on the "claim of right" doctrine announced in the *North American Oil* case, because this Court, referring in the *Freuler* case to the *North American Oil* case, said: "Section 219 had no bearing upon the question presented." Actually, what this Court said in the *Freuler* case was (p. 42):

> "The respondent relies on *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 76 L. ed. 1197, 52 S. Ct. 613. That case, however, involved the receipt of income in 1917 through a money award of a court. An appeal was taken and the award was not confirmed by the appellate court until 1922. The taxpayer's claim that the possibility of reversal shifted the receipt of the income to the latter year was overruled. Section 219 had no bearing upon the question presented."

Following the reasoning of the petitioner, the inapplicability of the *North American Oil* case becomes patent because Sec. 22(a) of the Income Tax Code was not involved in that case; in other words, what is taxable income was not the issue there.

The *North American Oil* case was decided in 1932. In 1946, subsequent to the date of most of the cases relied upon by petitioner which follow the *North American Oil* case, this Court decided the case of

Commissioner v. *Wilcox*, 327 U.S. 404,

and there stated explicitly the "claim of right" rule as applied to Sec. 22(a) of the Internal Revenue Code. That case, and not the multitude of "claim of right" cases cited by petitioner, is decisive of the instant case. There was a dissent by Justice Burton and the principal cases relied upon in the dissenting opinion, *National City Bank* v. *Helvering*, 98 F. 2d 93, *Barker* v. *McGruder*, 95 F. 2d 122, and *Chi. R. I. & P. R. Co.* v. *Commissioner*, 47 F. 2d 990, are also relied upon by petitioner in the instant case.

In the *Wilcox* case, Wilcox had embezzled certain funds from his employer, later gambling and losing them. He failed to report the embezzled moneys as income and the Commissioner sought to assess a deficiency. This Court held that the embezzled funds did not constitute income within Sec. 22 (a) of the Internal Revenue Code and rejected the Commissioner's contention that the "claim of right" doctrine was applicable. This Court said, in part, (p. 408):

> "For present purposes, however, it is enough to note that a taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain and (2) the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain. Without some bona fide legal or equitable claim, even though it be contingent or contested in nature, the taxpayer cannot be said to have received any gain or profit within the reach of § 22 (a). See *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 424, 76 L. ed. 1197, 1200, 53 S. Ct. 613. Nor can taxable income accrue from the mere receipt of

property or money which one is obliged to return or repay to the rightful owner, as in the case of a loan or credit. Taxable income may arise, to be sure, from the use or in connection with the use of such property. Thus if the taxpayer uses the property himself so as to secure a gain or profit therefrom, he may be taxable to that extent. And if the unconditional indebtedness is cancelled or retired, taxable income may adhere, under certain circumstances, to the taxpayer. But apart from such factors the bare receipt of property or money wholly belonging to another lacks the essential characteristics of a gain or profit within the meaning of § 22 (a)."

Under the facts in the instant case, the claim of right doctrine is not applicable because neither of the tests laid down in the *Wilcox* case has been met.

First, there was no presence of a "claim of right" to the excess bonus. The belief of the taxpayer and the Company that taxpayer was entitled to the money, being based upon a mutual mistake, is not a "claim of right" by taxpayer at all. (See p. 25, *supra*).

Second, as we have previously shown, there was a definite, unconditional obligation on the part of the taxpayer to repay or return the excess bonus, which obligation arose at the moment he received the bonus.

Petitioner says that the *Wilcox* case did not overrule or modify the rule of the *North American Oil* case. If it did neither, it certainly clarified the claim of right rule. Petitioner also says that the taxpayer received the money under claim of right, continuously maintained by him under the most "solemn circumstances", and that "His obligation to repay was not definite, unconditional or unqualified, but, on the contrary, was disputed and settled only after litigation." Thus petitioner concedes that if

the taxpayer's obligation to repay was definite, unconditional and unqualified, the claim of right doctrine does not apply. We believe that we have shown that when money is paid under a mistake, as it was here, the recipient's obligation to repay is definite, unconditional and unqualified, and that the decree of the Circuit Court of Cook County, Illinois, was a declaration of what was a fact.

The discussion of the *Wilcox* case and of petitioner's interpretation of the *Wilcox* case, in the opinion below, is apt. The Court of Claims said:

> "The *Wilcox* case concerned the taxability of an embezzler upon the proceeds of his crime. His duty to repay would certainly not lose its quality of being 'a definite, unconditional obligation' merely because at first he denied his crime and claimed that the money taken was his own, and persisted in that claim until he was convicted of the embezzlement. And the duty to repay of one civilly indebted because he had received money by mistake is no less 'a definite, unconditional obligation' because he refuses to recognize the obligation until the contract in connection with which he mistakenly received the money has been interpreted and enforced by adjudication." (R. 10)

The effect of the *Wilcox* case upon the *North American Oil* case is discussed at some length in *Gargaro v. United States*, 73 F. Supp. 973.

IV.

The Position Of The Government Is Unjust And Unfair To The Taxpayer.

The Circuit Court of Cook County, Illinois and the Court of Claims, found that the agreement between the

taxpayer and the Company was that the taxpayer's bonus for 1944 was to be ten per cent of the net profits of the Company *after* taxes (R. 7, 9). Therefore, when the taxpayer was paid and received the excess bonus (the difference between ten per cent of the net profits of the Company before taxes and ten per cent of the net profits after taxes) only one of two possibilities existed: Either (1) the taxpayer embezzled the excess bonus because he caused the Company to pay it, and he received it, knowing that the agreement between him and the Company was that his bonus was to be computed after taxes; or (2) he caused the Company to pay it, and he received it, as the result of a mutual mistake by the Company and by him. Upon the authority of *Commissioner* v. *Wilcox*, 327 U.S. 404, if the taxpayer embezzled the excess bonus, he is entitled to a refund. It would indeed be an anomaly if the taxpayer were entitled to the refund claimed by him if he embezzled the excess bonus, but not entitled to if, if he received it as the result of an honest mistake.

Concerning this situation, the Court of Claims said in *Gargaro* v. *United States*, 73 F. Supp. 973, at page 975:

> "We are asked to hold that an honest man who received money under a mistake and immediately restored it when the mistake was discovered, must pay an income tax upon it, whereas an embezzler who received money and used it (we suppose it is immaterial that he lost it in gambling) and did not restore it to the rightful owner, owes the Government no tax. We would suppose that if there was to be a difference in the treatment of these two situations, the difference should be that the honest taxpayer would be treated more considerately than the embezzler."

In 1944 the taxpayer received the excess bonus as the result of an honest mistake, and he paid taxes upon it. The Company deducted the excess bonus paid to the tax-

payer as an expense of the business and paid income taxes accordingly (R. 6). In 1945 the Company filed an amended return in which it deducted, as bonus compensation to taxpayer, the sum of $11,067.94 instead of the $21,924.00 deducted in its original return, and paid the additional tax based on the recomputation (R. 6). Therefore, the Government has received as income taxes for 1944, from the Company, its taxes based upon a deduction of the amount which was actually due to the taxpayer and which was $10,856.06 less than the amount that he was mistakenly paid in 1944, and, from the taxpayer, taxes based upon the amount mistakenly paid to him, and which was $10,856.06 in excess of the amount to which he was entitled. Thus, both the Company and the taxpayer paid income taxes for 1944 upon the excess bonus, which the taxpayer later refunded. Under no theory of consistency, fairness or justice can petitioner maintain the position that it is entitled to the additional income tax paid by the Company for 1944, but that the taxpayer is not entitled to a refund of the additional income tax for 1944 paid by him. As has been said by the Court of Claims in this case and similar cases, the Government's retention of the tax in this case is essentially unjust, and there is nothing to be said for it morally.

The unfairness and injustice of the petitioner's position has been well characterized in this case and previous similar cases by the Court of Claims. In *Greenwald* v. *United States*, 57 F. Supp. 569, the Court said (p. 573):

> "Where, however, one pays income taxes upon income which he physically receives, but which he is not allowed to keep, the Government's retention of the tax is essentially unjust. In a case such as the instant one, where, due to ignorance of fact, the tax-

payer had no choice in the matter, that injustice is complete."

In *Gargaro* v. *United States*, 73 F. Supp. 973, the Court said (p. 974):

> "We were impressed in that case, and, of course, are similarly impressed here, with the injustice of the Government's position. For the Government to insist upon keeping taxes paid to it by a taxpayer under the mistaken belief that he has received income for his own use and benefit, when in fact he received it only by reason of an honest mistake, and was obliged to and did give it back and got no benefit from it, there is nothing, to be said morally. If the Government can do this, it is only because the law is plainly so written, or because a fairer interpretation of an unclear law would throw the public revenues into serious confusion.
>
> "As to the law being plainly so written, it is not."

In the opinion below, the Court said:

> "We remind, however, that in the instant case, as also in the *Greenwald* and *Gargaro* cases, *supra*, the taxpayer having received the income, paid his tax, and did not ask the Government to wait for its revenue until he had completed his litigation or resolved his question otherwise. In all these cases the naked question has been whether the Government should keep money paid to it upon the mistaken assumption that the citizen had taxable income, when in truth he did not have the income, since he was under a legal obligation to return the money to his employer." (R. 11).

From every point of view of the equities of the situation, as well as the law, the respondent is entitled to the refund to which the Court of Claims said he was entitled.

Conclusion.

For the foregoing reasons, it is respectfully submitted that the decision of the Court of Claims should be affirmed.

Respectfully submitted,

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